Weekly Economic Commentary

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John Canally, CFA
Economist
LPL Financial

Highlights

The Eurozone is likely to be in a recession throughout 2013, despite the best efforts of the European Central Bank (ECB) and other policymakers.

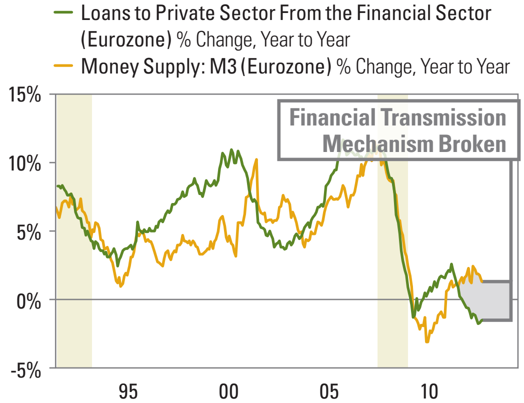
Fixing Europe's broken financial transmission mechanism should be at the top of European policymakers' long "to do" list.

Until the ECB (or other policymakers) can agree on a plan to get more credit to capital-starved small and medium-sized enterprises (SMEs) and European consumers, we do not think a meaningful recovery in Europe's economy is in the cards.

In the United States, the Federal Reserve's (Fed) quantitative easing (QE) program is helping to boost bank lending and the overall economy.

Please see the LPL Financial Research Weekly Calendar on page 3

1 The Financial Transmission Mechanism in Europe Is Broken



Source: European Central Bank, Haver Analytics 05/20/13

Shaded areas indicate recession.

What's Broken in Europe?

Last week (May 13–17), markets digested reports on gross domestic product (GDP) growth in the Eurozone during the first quarter of 2013 (please see "The Big Picture" for details about the Eurozone's structure). Overall real GDP in the Eurozone contracted by 0.2% in the first quarter of 2013, following the 0.6% drop in the fourth quarter of 2012. The Eurozone's economic contraction in the first quarter of 2013 was its sixth consecutive quarter of decline, dating back to the fourth quarter of 2011. Among the larger economies in Europe, only Germany (+0.1%) and Belgium (+0.1%) saw first quarter 2013 gains in their economies, while Austria's GDP was unchanged between the fourth quarter of 2012 and the first quarter of 2013. France (-0.2%), Italy (-0.5%), Spain (-0.5%), and the Netherlands (-0.1%) all saw their economies contract in the first quarter of 2013.

Among the smaller economies on the Eurozone's periphery, the news was just as bad, but the string of weak GDP readings extends back much further. Real GDP in Greece declined 0.6% in the first quarter of 2013, marking the 13th consecutive quarter of contraction. Greece's economy has now contracted in 20 of the past 23 quarters since mid-2007. Over that time, the Greek economy has shrunk by 23%. Real GDP in Portugal contracted by 0.3% in the first quarter of 2013, marking the 10th consecutive quarterly decline. Ireland's GDP fell just 0.1% in the first quarter of 2013, and it has managed just three quarters of growth since late 2010.

Looking ahead, financial markets seem to suggest that the double-dip recession in Europe—recession in 2008 and 2009, a modest, halting recovery in 2010 and early 2011, followed by another recession since mid-2011—may be ending, and that the Eurozone economy may eke out small gains in the second half of 2013. The consensus of economists (as compiled by Bloomberg News) sees real GDP in the Eurozone contracting in both the second and third quarters of 2013, before a modest upswing begins in late 2013. Our view remains that the Eurozone is likely to be in a recession throughout 2013, despite the best efforts of the ECB and other policymakers.

The Fix? Some Keys to Help Strengthen Eurozone Economic Growth

As we have noted in prior publications, there are several keys to help strengthen economic growth in the Eurozone, including, but not limited to:

- Fixing Europe's broken financial transmission mechanism;
- Broad-based labor market reforms;

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The Big Picture

Europe is defined as the 27 nations within the European Union. Seventeen of those nations currently use the euro as their currency, and the ECB serves as the central bank for these countries. These 17 nations are collectively known as the Eurozone nations. This group includes (in order of size of their respective economies):

Germany, France, Italy, Spain, the Netherlands, Belgium, Austria, Greece, Finland, Portugal, Ireland, Slovakia, Luxembourg, Slovenia, Cyprus, Estonia, and Malta.

The 17 nations that are part of the Eurozone, along with the other 10 European nations, comprise the European Union, a 27-member confederation of nations that share a single market, but not a single currency, government, central bank, etc. The 10 nations that are members of the European Union, but do not use the euro or the ECB (again, arranged by the size of their economies) are:

The United Kingdom, Poland, Sweden, Denmark, Czech Republic, Romania, Hungary, Bulgaria, Lithuania, and Latvia.

While sharing some of the economic and trade linkages with the 17 nations that use the euro and the ECB, each of these 10 nations has its own currency and central bank. To make matters even more confusing, Switzerland, Norway, and Iceland are also European nations with sizable economies, but are not members of the Eurozone (17 nations) or the European Union (27 nations) and also have their own currencies and central banks.

- European-wide banking reform (including a pan-European deposit insurance scheme); and
- Financial sector reforms.

In our view, fixing Europe's broken financial transmission mechanism should be at the top of European policymakers' long list of "to dos." The ECB, like almost every other major central bank around the globe, has lowered the rate at which banks can borrow from the ECB, expanded the ECB's balance sheet to purchase securities in the open market (QE), and tried to encourage banks and other financial institutions to lend, and businesses and consumers in Europe to borrow. The results, however, have not (as yet) had the intended effect: to get badly needed credit (in the form of loans) into the European economy, and especially to the consumer and small businesses. In short, the mechanism that allows credit to flow from the ECB, to banks and financial institutions, and finally to businesses and consumers was badly damaged in the Great Recession and its aftermath.

Major European-based global corporations are benefitting from the ECB's actions, and are taking advantage of low borrowing costs and relatively healthy—although not quite back to normal—European capital markets to issue debt and fund operations. While credit via traditional credit markets is flowing to large, global corporations in Europe, credit to SMEs, is severely restricted dampening economic activity.

How European Banks Can Help

As in the United States, most SMEs in Europe cannot borrow in the capital markets, so they rely on bank loans, and other types of bank-based funding for working capital and cash to expand existing business. This is especially true in countries at the periphery of Europe, like Greece, Portugal, Cyprus, and increasingly in core European nations like Spain and Italy. The problem is that the main conduits of the ECB's low rates and QE policies are European banks, which:

- Are undercapitalized;
- Are reluctant to lend;
- Are losing deposits;
- Lack regulatory clarity; and
- Have impaired balance sheets.

Therefore, European banks are not lending, or more precisely, not lending enough.

Figure 1 shows the breakdown in the financial transmission mechanism in Europe. Money supply growth (a decent proxy for the ECB's actions to pump liquidity into the system) is running at around 2–3% year over year. Not robust growth, but enough to foster some lending by financial institutions. The other line on Figure 1 shows that despite the 2–3% growth in money supply in Europe, loans by financial institutions in Europe to private sector borrowers (SMEs and consumers) have turned negative. Therefore, LPL Financial Research Weekly Calendar

2013	U.S. Data	Fed	Global Notables
20 May		Evans*	
21 May		Bullard Dudley*	
22 May	▪ Existing Home Sales (Apr)	▪ **FOMC Minutes** ▪ **Bernanke Testimony**	▪ **China: Flash PMI—Manufacturing (May)** ▪ **Japan: Bank of Japan Meeting**
23 May	▪ **Initial Claims (5/18)** ▪ **Markit PMI (May)** ▪ Home Price Index (Mar) ▪ New Home Sales (Apr)	Bullard	▪ **Eurozone: PMI (May)** ▪ **ECB's Draghi speaks in London** ▪ Spain: Bond Auction ▪ Eurozone: Consumer Confidence (May)
24 May	▪ **Durable Goods Shipments and Orders (Apr)**		▪ **Germany: IFO Survey (May)**

Hawks: Fed officials who favor the low inflation side of the Fed's dual mandate of low inflation and full employment

Doves: Fed officials who favor the full employment side of the Fed's dual mandate

* Voting members of the Federal Open Market Committee (FOMC)

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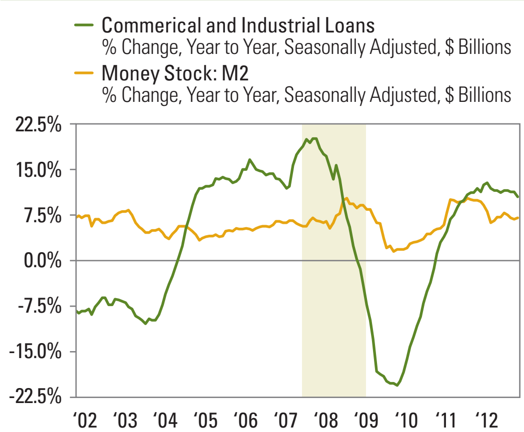
2 In the United States, the Fed's QE Program Is Helping To Boost Bank Lending and the Overall Economy



Source: Federal Reserve, Haver Analytics 05/20/13

Shaded areas indicate recession.

credit to two key components of the Eurozone economy is contracting. The gap between these two lines is a good proxy for the broken financial transmission mechanism in Europe.

A quick look at Figure 2, which shows similar U.S. metrics (M2: money supply and bank lending), reveals that the financial transmission mechanism—while not quite back to normal—is functioning a lot better than Europe's. M2 growth is running at around 7% year over year, while bank lending to businesses is running close to 10% year over year.

How the ECB and Policymakers Can Help

What would help to repair Europe's broken transmission mechanism, and in turn, help to boost economic growth in the Eurozone? One way would be if the ECB was willing to take some credit risk on their balance sheet, and take an approach similar to the Bank of England's (BOE) "credit easing" program. The BOE announced in late 2011 and mid-2012 that it would provide cheap loans and loan guarantees to the banking system to encourage the banks to lend more. Or, the ECB could decide to make loans directly to SMEs, essentially bypassing the broken European financial mechanism. Such a move by the ECB, of course, remains difficult—although not impossible—to achieve, given the fractured state of banking regulation in Europe and reluctance by key constituencies within the Eurozone to expand the ECB's mandate. The bottom line is that until the ECB (or other policymakers) can agree on a plan to get more credit to capital-starved SMEs and consumers in Europe, we don't think a meaningful recovery in Europe's economy is in the cards. ▪

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk including loss of principal.

Quantitative easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

INDEX DESCRIPTIONS

Purchasing Managers' Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

This research material has been prepared by LPL Financial.

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